SHALL THE GOVERNMENT REGULATE THE SALE OF SECURITIES?

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As an expression of personal opinion this chapter, written for the special issue of *The Annals*, could be made shorter than the famous chapter "On the Snakes of Ireland" in the old history and description of that country which contained only the statement "There are no snakes in Ireland." On that literary method this chapter would consist of the single word "No." Though the ancient historian thought his treatment adequate, presumably if he had written for *The Annals*, the members of the Academy of Political and Social Science would not feel that he had sufficiently considered his subject unless he had given some statement of the services of Saint Patrick and shown that a large indulgence in alcoholic liquor need not hold the same terror for an Irishman in his native land as for a man in some country less fortunate in respect to snakes. So this chapter will defend the thesis, which expresses a personal belief, that the government should not regulate the sale of securities.

Such a statement is not intended to include the regulation for rate-making purposes of the issuance and sale by public service corporations of their securities. It is the primary intention of such regulation to protect the interests of the user of the service of the corporation and see that he gets as much as possible for his money. It may not be amiss, however, to express an opinion that even this regulation cannot do much toward the accomplishment of its purpose. Our discussion here has in mind a regulation of the sale of securities for the purpose of protecting the interests of the people who purchase them, not the people who consume the product of the enterprise the securities are issued to finance. Nevertheless, our title does not limit the scope of the discussion by including the word "industrial" to make it read "Should the government regulate the sale of the securities of industrial corporations?" The ordinary scope of the regulation of the issuance and sale of public service

corporation securities stops with the sale of the securities by the issuing corporation. A public service commission is not concerned with any further transactions in the securities. They may even be fraudulent, yet in no way concern the public service commission.

To keep within reasonable limits, this discussion cannot in any way concern itself with government regulation of such public markets for securities as the stock exchanges. That is a sufficient subject for separate treatment. With this introductory word enough has been said to indicate the scope of our inquiry.

If government regulation of the sale of securities were desirable in itself, the duality and multiplicity of jurisdictions inherent in our form of government increase enormously the difficulty of such regulation. Probably the form of our government does not add any more to the difficulties of legislation on this subject than on any other economic matter.

Duality of jurisdiction, everywhere the federal and the state government over the same area, and multiplicity of jurisdiction, the many state governments within what may be called a single economic area, make much of our economic legislation at the same time irksome and inefficient. However admirable the division of powers between our federal and state governments at the time of the adoption of our constitution, and however really separate then the subjects of federal and state jurisdiction, economic development has now so blurred many of the lines that they are practically indistinguishable. In many arenas government with us is in the position of a gladiator entangled in the meshes of a net woven of the intricate situations brought about by dual and multiple jurisdiction. As a people we do not generally know what this ailment is we are suffering from, or indeed, that we are suffering from any ailment at all. Business men whose affairs extend over many states are dimly conscious that something is the matter. Lawyers whose occupation consists of piloting the affairs of these business men through the channel of a legal passage find the work imposes too much of a strain to give them any opportunity to consider how the harbor might be cleared.

This discussion must not get too far away from the subject assigned. It would be easy to get lost in the forest of difficulties which our form of government has grown. This chapter must confine itself especially to those which grow in the path of government

regulation of the sale of securities. Some of our courts have decided that securities are subjects of commerce and that therefore when they enter into a transaction that covers more than one state they are subjects of interstate commerce. If that is so, and it seems so reasonable a conclusion as to be ultimately sustained, then any regulation by the states must not violate the rights of interstate commerce.

If the question be one of regulation by the federal government, it is difficult to see how that government can procure any jurisdiction except through its right to regulate interstate commerce and its control of the mails. On this assumption such transactions as do not constitute interstate commerce or do not utilize the mails are outside of its power to regulate. Even for the federal government to utilize its control of the mails to regulate transactions which are not interstate commerce, in the absence of fraud, which the postal act, with the unanimous approval of everybody but the fraudulently minded, already provides for, would seem an altogether unwarranted stretching of the spirit of the constitution. It is true that such a strain has been proposed from some quarters for the purpose of giving the federal government a power over the stock exchanges, but it would seem an essential violence to constitutional function. Apparently regulation cannot be even reasonably complete unless both federal and state governments take a hand at it, and come to some proper division of it.

The federal government has been sufficiently reticent with regulation and has contented itself with the simple provision in the postal act against using the mails for fraudulent purposes. Under this briefest of legislative expressions it has done yeoman's service in protecting the unwary against the criminal. But this provision does not bestow on the federal government any more power than every state possesses without any legislation at all. We have had so many state enactments purposing to go further than this that if Mr. Average Citizen realized how many there are and how far they go he should grunt with content in the knowledge of the assurance the state gives him that there will be no lemon among the hand-picked golden apples which pass the state inspection of securities presented for his consumption.

Let us make, however, the too large assumption that government regulation of the sale of securities may be feasible, so far as the

ability to regulate is concerned, and consider whether such regulation is desirable. Laymen who advocate it are rather likely to point to pure food laws as an analogy. They quite overlook the fact that pure food laws are essentially laws against misrepresentation, and do not prevent the dealing in a commodity provided it is not represented as good for food. Meat may have reached a point where it is not a healthful food. That does not prevent it from being sold to a fertilizer factory.

Every purchase of a security involves two things, it is a commitment of capital and an assumption of risk. Every income return promised or expected from a security involves the reward to which a man is entitled for the benefit he confers in the accumulation of capital and a premium for the assumption of risk in committing his capital to the special use. It must always be borne in mind, too, that a limitation on the right to sell involved in any regulation of the sale of securities that would forbid the sale of any particular securities is also a limitation on the right to buy. Very likely it would be a good thing for society if the running of some risks could be prevented. Undoubtedly society suffers grave losses to its capital fund through the assumption of risks in which the probability of profit is not commensurate with the possibility of disaster. But any argument for a regulation of the sale of securities based on that premise could not logically stop short of an advocacy of a regulation of the assumption of risk in general. Such a regulation would have to investigate the intention of a farmer to withdraw his savings bank account to expend in boring for oil on his farm, or even to expend in draining or irrigating some part of it. Obviously nothing of the kind can be done without limiting the entire scope of the freedom of individual action.

So, as a first conclusion drawn about the desirability of government regulation of the sale of securities, it may be stated that any regulation directed generally to limiting the amount of risk which may be offered with an offer to sell securities is not socially expedient. Indeed it would run directly counter to our constitutional guaranties of freedom of contract. Nevertheless, nearly all of our multitudinous legislation on the subject during the past few years has been directed towards this end.

In spite of what has just been said we do have and always have had some regulation of the assumption of risk. It has, however,

in the past always been directed to the buyer rather than to the seller. This statement refers to investments made in an essentially fiduciary capacity. The investments which trustees, banks, insurance companies and the like may make are often strictly and specifically limited in the character of risks that may be assumed. But that the state should attempt to step in between two people, a seller acting without fraud and a buyer *compos mentis* acting on his own behalf and say that a bargain shall not be consummated is not short of amazing. That it has been so widely attempted shows with what a reckless debonair lack of taking thought we legislate.

It is urged that the buyer and seller of securities do not meet on equal ground, that in the nature of the situation the buyer is often and perhaps generally not qualified to judge of his bargain. But that observation cannot be confined to the buyer and seller of securities. It may be equally true of the buyer and seller of a suit of clothes, of an automobile, of a house and lot, of a painting, of anything which may be a subject of the transaction of purchase and sale.

If from any possible purpose of government regulation of the sale of securities we exclude any limitation of the amount of risk which may be offered, what other purpose may government regulation have? It may look to the prevention of fraud. Is there any way in which it can so regulate the sale of securities as to prevent fraud before it is prepared to assert in a particular case that the fraudulent intent exists? If it waits to punish the fraud after it is committed, or, as in the case of the federal government in the use of the mails, watches some person under suspicion and waits until it can prove fraudulent intent, which practically it cannot prove until fraud is committed, then much injury is irreparably done before further injury is stopped. Most of the regulatory legislation which has been passed has looked to some form of inspection of the security before it is offered for sale. This argument has taken the ground that the government ought not to prevent a transaction unless there is a fraudulent intent on the part of the vendor. Without considering constitutional difficulties, should every transaction be held up until the government can determine the absence of intent to defraud? That would essentially make a presumption of guilt until innocence were proved. Besides, entirely disregarding questions of the right or wrong of such a procedure, it is utterly impracticable. Consider the long legal process necessary to determine

fraud after it has been committed. It would certainly not be any easier to determine intent before a transaction than after. Anything less than this care applied to the determination of the facts before the transaction can hardly be contemplated as a proper safeguarding of the interests of the parties. Imagine the state holding up every man as he emerges from his house and attempting to determine that he has nothing but a peaceful intent in walking abroad. That would be hardly more absurd than the attempt to hold up all transactions in securities until the government could establish to its satisfaction that they are to be offered for sale with only a good intent.

Government regulation might look to compelling a full disclosure of the facts. But just what would this mean? There are multitudes of transactions in which the facts are just as well known to one party as to the other, or are just as available to one party as to the other. It is in the nature of the business done that multitudes of transactions take place so quickly that there is no time to say more than "offered at" by the seller and "taken" by the buyer. The existence of a quick market for certain of our securities is one of the most important facts of the financial aspect of our modern economic life. If every seller were compelled by statute to make a full disclosure of all the facts, of the properties, the income account, the balance sheet of the issuing corporation, and a hundred other matters that comprise the "facts," such a market would be impossible. In a large proportion of all transactions in securities it would be as absurd to compel this disclosure as to compel a man who is making a sale of so many bushels of wheat of a certain grade to make a statement, a "disclosure" of the chemical analysis, the specific gravity of that wheat, where it was grown, and by whom. Imagine one broker in the process of making a sale playing the part of the Ancient Mariner and with his glittering eye holding the attention of the other broker and insisting on making a full disclosure of all the facts. This situation is not limited to transactions on the stock exchange. It is a well-known fact that of the bond issues listed on the New York Stock Exchange only a small proportion of the sales are made on the exchange. Many issues not listed enjoy as active or almost as active a market as the listed issues. Activity of dealings grades off gradually and does not show any clearly defined line between active and inactive securities.

Even with the most inactive security it would be impossible in most cases for the vendor to comply with a requirement that any specified set of facts be furnished. A jurisdiction having control over the issuing corporation might compel it on its sale of its own securities to disclose a required set of facts. Once the securities pass into the hands of the purchaser, however, he cannot compel the corporation to furnish him with the facts in order that he may disclose them on a resale. Even if he is the first purchaser from the corporation and received a full "disclosure" from the corporation at the time he made his purchase, as, say, the banker who bought the securities for resale, the "facts" he had from the corporation are obsolete a year, or, it may be, even a day after he made the purchase. Suppose a disastrous fire happened the day after the purchase, and the buyer cannot discover the extent of the damage it will cause to the business, what value have the "facts" in his possession.

Still considering the idea of publicity, suppose the legislation compelling it foresaw this difficulty of the purchaser, and to enable him to make the required disclosure it gave him the right to require the corporation to disclose to him the stipulated facts. Then what shall the "facts" be? The most recent annual statement? But that, as we have seen, may in any given case be obsolete the day after it is issued. Shall the corporation be required to issue a new report at the request of any security owner, who will, perforce, be obliged to make the request before he can effect a sale? That is *reductio ad absurdum.*

Even this situation does not present the greatest difficulty. The absolutely insurmountable difficulty lies in the fact that the state which has jurisdiction over the sale may not have any jurisdiction at all over the corporation whose securities are the subject of the sale. If the legislation kept within the limits of its power and applied only to corporations within the jurisdiction, it would obviously be unavailing against the get-rich-quick scheme. If, on the other hand, it applied to all transactions, and the owner of securities, compelled to make disclosures of specified facts, were left to get the facts as best he might, he could not sell unless he got them, and ordinarily would not be able to sell at all securities of corporations outside the jurisdiction. Disregarding the constitutional difficulties of this situation, the interference with interstate commerce, freedom of contract and other, any such situation would result in an

immediate restriction of all transactions in securities to those securities originating within the jurisdiction. This would choke the channels through which capital flows from those communities which relatively have a surplus to those which relatively are deficient, and take the life out of the country's economic development. Or, what would really happen, as happens to so much of our ill-advised legislation with such unhappy results to our political morality, the statutes would become dead letters, one more accretion from one more flood of endeavor, honestly intended, or, at least, largely so, but unintelligently considered, to cure a social ill by the applying of ink to paper through vote of a legislature and binding it in a statute book.

A requirement of publicity of facts about the issuing corporation on the sale of its securities can avail little unless the purchaser wants the facts. Very largely he does not want the facts. He prefers to hold some one morally responsible for the safety of his investment rather than to exercise his own judgment on the merits of the security. Often his judgment of the moral risk is decidedly bad, and often he is willing to assume moral risks greater than any investment risk he would be willing to assume. Thinking is hard work, and learning something about corporation finance and principles of investment involves more thinking than many people are willing to give to the care of their savings.

The fact is we cannot make people cautious by statute any more than we can make them thrifty by statute. It is of no avail to compel complete disclosure unless we can compel the purchaser to give some consideration to the disclosure. Enforcement of sumptuary laws compelling thrift would be as a mere leading of a donkey to water compared with which an enforcement of laws looking towards compulsory caution would be like making the proverbial donkey drink. In the judgment of risks the most skilled and astute make mistakes. We cannot hope to prevent losses through regulation of the sale of securities. The extent of which losses might be diminished would be more than offset, even in the mildest regulation, by greater losses imposed through the restriction of business. Certainly under our form of government we cannot do better than leave the matter to the old criminal and civil liability for fraud. It is hard to discover that the numerous enactments during the past few years have in the least benefited the community.